LIBRARY
SUPREME COURT, U. S.

Office-Supreme Court, U.S.
FILED
JUL 5 1966
JOHN F. DAVIS, CLERK

In the

Supreme Court of the United States

OCTOBER TERM, 1966

No. 313

WARREN BURNETT AND EMMA BURNETT,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

OTIS BAIN GARY,
15th Floor, 211 N. Ervay Building,
Dallas, Texas 75201,
Attorney for Petitioners.

WARLICK PRESS, INC.—2263 VALDINA STREET—DALLAS—ME 1-3130

TABLE OF CONTENTS

	Page
Opinions Below	1
Jurisdiction	2
Question Presented	2
Statute Involved	2
Statement	2
Reasons for Granting the Writ	5
Conclusion	11
Certificate of Service	12
Appendix:	
Opinion of the United States Court of Appeals for the Fifth Circuit	A-1
Judgment of the Court of Appeals	A-13
Order of the Court of Appeals denying Motion for Rehearing	A-15

Table of Authorities

Cases

	Page
Bercaw v. Commissioner, 165 F. 2d 521 (4th Cir. 1948)	8
Milton Bradley Co. v. United States, 146 F. 2d 541 (1st Cir. 1944)	8
Clark v. Commissioner, 205 F. 2d 353 (2nd Cir. 153), affirming per curiam 18 T.C. 780 (1952)	8
Commissioner v. Tellier, 86 S. Ct. 1118 (1966)	5
J. Fleet Cowden, 24 T.C. Memo 1528 (1965)	10
Gilman v. Commissioner, 53 F. 2d 47 (8th Cir. 1931)	8
Reginald G. Hearn, 36 T.C. 672 (1961), affirmed 309 F. 2d 431 (9th Cir. 1962), cert. denied 373 U. S. 909 (1963)	10
Higgins v. Smith, 308 U.S. 473 (1940)	5, 6
Francis H. Monek, T.C. Memo 1966-110 (May 25, 1966)	10
RCA Communications, Inc. v. United States, 277 F. 2d 164 (Ct. Cl. 1960)	9
United States v. Virgin, Jr., 230 F. 2d 880 (5th Cir. 1956)	8
Zimmerman v. United States, 318 F. 2d 611 (9th Cir. 1963)	7, 8

Statutes

Internal Revenue Code of 1954, §26 U.S.C. Section 162(a)	2, 5, 9
Section 6213(a)	4
28 U.S.C., Section 1254(1)	2

In the

Supreme Court of the United States

OCTOBER TERM, 1966

No. .....

WARREN BURNETT AND EMMA BURNETT,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioners, Warren Burnett and Emma Burnett, pray that a writ of certiorari issue to review the final judgment of the United States Court of Appeals for the Fifth Circuit entered in the above case on April 5, 1966.

OPINIONS BELOW

The opinion of the Tax Court is reported at 42 T.C. 9.

The opinion of the Court of Appeals is reported at 356 F. 2d 755.

JURISDICTION

The original judgment of the Court of Appeals was entered on February 15, 1966. A timely petition for rehearing filed on March 8, 1966, was denied on April 5, 1966, on which date judgment became final. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

QUESTION PRESENTED

Whether the petitioner attorney could deduct as ordinary and necessary expenses of his law practice amounts he disbursed to certain of his financially needy clients to prevent the premature and improvident settlement of their personal injury or workmen's compensation claims, where the petitioner had no right, but at most a mere expectation, of recovery of any such disbursements out of whatever recovery he might ultimately effect on the client's claim.

STATUTE INVOLVED

The pertinent statute is §162(a) of the Internal Revenue Code of 1954:

> "(a) In general. — There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *" 26 U.S.C. §162(a).

STATEMENT

The petitioner, Warren Burnett, is an attorney whose practice consists primarily of representing plaintiffs in personal injury and workmen's compensation litigation. For several years prior to and including 1961 he disbursed money

to certain of his injured clients, principally to provide assistance toward the cost of the bare necessities of life during the 1 to 5 years while their claims were pending. He made these disbursements because the recipients, unemployed people of low income with families to support, would otherwise have had no choice but to settle their claims for nominal amounts before the time required to obtain a trial determination or pre-trial settlement. He believed that he could not properly and effectively represent these clients without furnishing them such funds. His experience has demonstrated that substantially larger recoveries result from preserving his clients' claims until set for trial in the orderly course of the judicial process, and because the petitioner generally receives a percentage fee, this practice results in increasing his own income. Disbursements of this type are customary among Texas attorneys who handle similar litigation and when, as in the petitioner's case, they are not made as a means of attracting business, the disbursements are permitted by the Canons of Ethics of the State Bar of Texas.

None of the petitioner's disbursements to clients was repayable to him unless, until and to the extent of any recovery he was able personally to obtain for the client. In the meantime, throughout the period while any claim was pending and subject to all the uncertainties and hazards of litigation of this type, the petitioner had at best an expectation or hope of eventual reimbursement upon successful disposition of the claim. Generally the petitioner recovered less than one-third of his disbursements within

the year he paid them out, and at the end of 1961 he had recovered only about 56% of his total disbursements to clients during the five prior years.

As part of the cash basis which the petitioner used in accounting for income and expenses of his law practice, he regularly treated these disbursements as expenses when paid and any repayments as income when received. Because his practice was growing, the disbursements exceeded the repayments each year, and he consistently deducted the excess as an ordinary and necessary business expense in computing his taxable income.

Upon examination of the petitioner's return for 1961 the Commissioner disallowed the claimed business expense deduction, treating the disbursements in issue as non-deductible when paid and any recoveries as non-taxable when received. The petitioner, and his wife by reason of her community interest in his income and expenses under Texas law, thereupon contested the resulting deficiency in their income tax by petitions timely filed with the Tax Court pursuant to Section 6213(a) of the Internal Revenue Code of 1954, 26 U.S.C. §6213(a).

The Tax Court sustained the Commissioner's disallowance, basing its decision on the petitioner's expectation of recovery of the disbursements and his recovery record with respect to disbursements made in the years 1957 through 1960.

The petitioners timely filed a petition for review by the United States Court of Appeals for the Fifth Circuit of the

Tax Court decision. The Court of Appeals affirmed that decision as to the petitioner's disbursements to his clients, characterizing them as "advances * * * which were virtually certain to be repaid" and "which were intended to, and did, operate as loans." This decision of the Court of Appeals is the one the petitioners ask this Court to review.

The petitioners also contested in the Tax Court the disallowance by the Commissioner of deductions claimed for payments of certain court costs for clients and of other amounts paid to clients' creditors in 1961. The Tax Court sustained the disallowance and the petitioners appealed this determination to the Court of Appeals, which reversed this portion of the Tax Court decision and remanded these issues to the Tax Court to hear further evidence concerning the deductibility of the items involved. This petition is not concerned with these remanded issues.

REASONS FOR GRANTING THE WRIT

In computing taxable income for each annual accounting period a cash basis taxpayer is entitled to deduct at the time of outlay all his expenditures which are ordinary and necessary expenses of his business or profession. Statutory authority for this principle of Federal income taxation is contained in Section 162(a) of the Internal Revenue Code. Judicial authority is found in many decisions of this Court affirming the proposition that the Federal income tax is "a tax on net income," *Commissioner v. Tellier*, 86 S.Ct. 1118, 1120 (1966), by which the Congress intended "to tax earnings and profits less expenses and losses," *Higgins v.*

Smith, 308 U.S. 473, 477 (1940). The Court of Appeals, in disallowing a deduction for the petitioner's disbursements to clients, has reached a conclusion which fails to apply this principle and is in conflict with the decisions of other Courts of Appeal and the Court of Claims. This Court should review that decision not only because it is erroneous on the facts of this case but also because its result raises important questions in the proper administration of the tax laws affecting many people.

1. The decision of the Court of Appeals was erroneous because of the nature of the petitioner's disbursements and the practical economic consequences of such expenditures:

a. In carrying on his law practice the petitioner, as does every practicing attorney, regularly incurs various expenditures to place him in a position to represent his clients properly and efficiently and thus to earn his fees. He must maintain an office, hire employees to assist him, pay professional dues, subscribe to current legal periodicals, and the like. Without question all of these expenditures are currently deductible as ordinary and necessary business expenses, even though he makes them with the expectation or hope of recovering most of his outlay in the eventual compensation he may receive from rendering future legal services. Here the petitioner regarded the disbursements to his clients as necessary to enable him to represent them effectively, and his experience proved that because he made them the clients were better served and he himself was better paid. The causal relationship between

expenditure and income was much closer in these disbursements than in any of the deductible expenditures enumerated above which are made simply to keep open the doors of the petitioner's law office. Such disbursements should therefore qualify as business expenses notwithstanding the petitioner's expectation or hope of recovery of most of them at some uncertain future date, generally beyond the end of his current taxable year.

b. Except for capital expenditures and allowable depreciation, the net earnings of the petitioner from his practice for any taxable year were reflected realistically in his cash position, that is, his cash receipts less his cash outlay. Money providing the wherewithal to make disbursements to his clients was generated only out of his fees, and when he paid out that money to clients he had no assurance of any recovery during that taxable year or thereafter. To impose a tax on his current income without allowing a current deduction for such disbursements has the effect of taxing him on gross income.

2. The decision of the Court of Appeals disallowing a deduction for the petitioner's disbursements on the ground that they "were intended to, and did, operate as loans" is in conflict with the principle consistently recognized and applied by several Courts of Appeals that no loan or debt results from a disbursement which is only conditionally repayable until the condition occurs. *Zimmerman v. United States*, 318 F. 2d 611 (9th Cir. 1963); *United States v.*

Virgin, Jr., 230 F. 2d 880 (5th Cir. 1956); *Clark v. Commissioner*, 205 F. 2d 353 (2nd Cir. 1953), affirming per curiam 18 T.C. 780 (1952); *Bercaw v. Commissioner*, 165 F. 2d 521 (4th Cir. 1948); *Milton Bradley Co. v. United States*, 146 F. 2d 541 (1st Cir. 1944); and *Gilman v. Commissioner*, 53 F. 2d 47 (8th Cir. 1931). As Circuit Judge Moore states in the opinion of the Court of Appeals here, these decisions were concerned with whether or not particular obligations could give rise to a bad debt deduction (in the *Zimmerman*, *Clark*, *Bercaw* and *Bradley Co.* cases) or an "interest paid" deduction (in the *Virgin* and *Gilman* cases), and wherever the obligation was not unconditionally repayable the courts have uniformly disallowed deductions of both types for lack of a supporting indebtedness. However, there is properly no limitation on the application of the definition of a loan or debt appearing in any of these decisions. The failure of the Court of Appeals to apply this widely accepted definition so as to find that the petitioner's conditionally recoverable disbursements were not loans, nor that they "operated" as loans, creates uncertainty in all areas in which the tax consequences of conditional advances must be determined. Furthermore, when the decision of the Court of Appeals in the instant case disallowing an expense deduction at the time of making a conditionally recoverable disbursement is laid alongside the appellate decisions disallowing a bad debt deduction for such a disbursement at the time it becomes worthless, only one conclusion follows: that is, to the extent the petitioner, or any other taxpayer making similar expenditures, fails to recover any disbursement he will apparently find himself with an in-

disputable out-of-pocket business loss but no tax deduction at any time! The petitioners do not believe that the Congress intended Section 162(a) to be interpreted so as to produce this result. Such a conclusion projects the error of the Court of Appeals decision here into bold relief. It highlights the imperativeness of a review of that decision by this Court.

3. The decision of the Court of Appeals disallowing the petitioner's disbursements as deductible business expenses was based on the petitioner's expectation of recovery and his actual recovery of substantial amounts of such disbursements. This holding is squarely in conflict with the decision of the Court of Claims in *RCA Communications, Inc. v. United States*, 277 F. 2d 164 (1960), which allowed a business expense deduction for disbursements of a business nature even though the taxpayer made them "expecting reimbursement" and was later repaid. (p. 167). By introducing the subjective factor of a taxpayer's expectation into the determination of whether or not an otherwise deductible expenditure thereby becomes a non-deductible advance, the decision of the Court of Appeals creates uncertainty as to the tax consequences of all business expenditures made with a possibility of reimbursement.

4. As referred to in the Statement above, the practice of making disbursements to indigent clients with personal injury claims is customary among attorneys in Texas who represent such persons, and it is believed to be widespread throughout the United States. Besides this case three others have been decided in the courts within the last five

years involving the deductibility of disbursements to or for their clients by attorneys practicing in different parts of the country. *Reginald G. Hearn*, 36 T.C. 672 (1961), affirmed 309 F. 2d 431 (9th Cir. 1962), cert. denied, 373 U.S. 909 (1963) (attorney in California); *J. Fleet Cowden*, 24 T.C. Memo 1528 (1965), pending on appeal before the Court of Appeals for the First Circuit (attorney in Massachusetts); and *Francis H. Monek*, T.C. Memo 1966-110 (May 25, 1966) (attorney in Illinois). An amicus brief filed in 1962 in the Court of Appeals for the Ninth Circuit in the *Hearn* case by attorneys for the National Association of Claimant's Counsel of America, an organization of plaintiffs' trial attorneys then numbering more than 12,000 members from all the states of the United States, states that it is "common practice" for attorneys with any substantial litigation practice to make various expenditures for their clients in connection with preparing a case for trial with merely an "expectation of reimbursement at the conclusion of the case" but otherwise on a contingent basis. That brief further states that at a poll taken of the NACCA membership at its annual convention in 1962 more than 70% of its members deducted such disbursements as a business expense when paid and in the event of successful outcome reported the recaptured expense as income in the year of recovery. Thus, the decision of the Court of Appeals in this case will overturn the tax accounting practices of thousands of practicing attorneys. Moreover, it would appear obvious that if the petitioner is not permitted to deduct the expenditures in issue he cannot economically afford to continue his disbursement practice. Based on his experi-

ence this will mean that many of his clients will be compelled to accept settlements which do not do justice to them for their injuries. Thus, the harsh tax consequences to the petitioner will be visited upon many needy and deserving individuals who cannot get from any other source the financial assistance vital to their survival during the period required to see their claims to a fair and proper conclusion. Repercussions touching so many people should not be permitted to occur without a full review, consideration and determination by this Court.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

OTIS BAIN GARY,
15th Floor, 211 N. Ervay
Building,
Dallas, Texas 75201,
Attorney for Petitioners.

July 1, 1966

CERTIFICATE OF SERVICE

I, Otis Bain Gary, attorney for Warren Burnett and Emma Burnett, petitioners herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that, on the 2nd day of July 1966, I served copies of the foregoing Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit on the following parties, as follows:

1. On Thurgood Marshall, Esq., Solicitor General of the United States, by mailing a copy to him in a duly addressed envelope, with air mail postage prepaid, at the Department of Justice, Washington 25, D.C.

2. On each of the following attorneys of record who represented the Commissioner of Internal Revenue in the Court of Appeals:

Mitchell Rogovin, Esq.,
Assistant Attorney General
Tax Division, Department of Justice
Washington, D.C.

Lee A. Jackson, Esq.,
Chief, Appellate Section
Tax Division, Department of Justice
Washington, D.C.

Robert N. Anderson, Esq.,
Attorney
Department of Justice
Washington, D.C.

Fred E. Youngman, Esq.,
Attorney
Department of Justice
Washington, D.C.

by mailing a copy to him in a duly addressed envelope, with air mail postage prepaid, at the respective addresses shown above.

3. On the Commissioner of Internal Revenue, respondent herein, by mailing a copy, in a duly addressed envelope, with air mail postage prepaid, to Sheldon S. Cohen, Esq., Commissioner of Internal Revenue, Washington 25, D.C.

Otis Bain Barry

Attorney for Petitioners

15th Floor, 211 N. Ervay Building
Dallas, Texas 75201

APPENDIX

OPINION, JUDGMENT AND ORDER DENYING PETITION FOR REHEARING OF THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

In the

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 21884

WARREN BURNETT and EMMA BURNETT,
Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for Review of Decisions of the Tax Court of the United States (Texas Case).

(February 15, 1966.)

Before RIVES, BROWN and MOORE,* Circuit Judges.

MOORE, Circuit Judge: This is a petition to review a decision of the Tax Court, 42 T.C. 9 (1964), affirming the assessment of federal income tax deficiencies for the year 1961 against petitioners Warren and Emma Burnett, hus-

* Of the Second Circuit, sitting by designation.

band and wife,[1] (hereinafter referred to singularly as petitioner), which resulted from the disallowance of deductions, totalling $50,417.18, claimed as business expenses under Section 162(a) of the Internal Revenue Code of 1954, 26 U.S.C. §162(a).

Petitioner is an attorney in Odessa, Texas, whose practice is primarily devoted to representing plaintiffs in workmen's compensation and personal injury litigation on a contingent fee basis. As apparently is the custom among certain attorneys in Texas representing plaintiffs, petitioner, during the years 1957 through 1961, made disbursements to or on behalf of certain of his clients principally to provide for their living expenses incurred in the period during which he handled their claims. The clients, however, were not unconditionally obligated to repay such amounts. Rather, the disbursements were made with the understanding that repayment would occur only if, when and to the extent that petitioner was successful in effecting a recovery of a client's claim; and the excess, if any, was to be shared between petitioner and the client according to previously agreed upon percentages. From 1957 to 1961, such disbursements were made to 450 of the approximately 2,200 persons represented by petitioner. The total disbursements for each year during that period were $10,819.85 for 1957; $22,444.03 for 1958; $38,016.02 for 1959; $91,061.46 for 1960; and $169,676.20 for 1961; of which, as of the close of 1961,

[1] This case involves the deductibility from income of certain expenditures made by Warren Burnett to clients in the conduct of his law practice. His wife is a party because the income involved was community property under the laws of Texas, and was reported by them on separate returns filed on the cash receipts and disbursements basis.

petitioner had recovered 96%, 83%, 88%, 75% and 34%, respectively.

Petitioner, who employs the cash basis of accounting, treated the disbursements as expenses when paid, and the recoveries as income when received. Consistently since 1957, on his federal income tax returns, petitioner has claimed as a business expense deduction the excess of distributions made in the respective taxable years over the recoveries received in that year. In 1961, petitioner claimed the amount of $50,417.18 as a business expense deduction for "Advances to Clients Net of Collection on Settlement,"[2] but the deductions were disallowed by the Commissioner of Internal Revenue. Petitioner instituted proceedings in the Tax Court challenging the Commissioner's action, contending that the disbursements constituted ordinary and necessary business expenses deductible under Section 162(a) of the Internal Revenue Code of 1954. Petitioner testified before the Tax Court that it was customary for him, when making payments to clients, carefully to evaluate the strength of a client's claim, and that he endeavored to keep the amount of a disbursement to a client under the expected recovery on his claim. The Tax Court, relying on the above testimony

[2] These amounts represented their respective community shares of the amount of $50,417.18, which was the excess in 1961 of Warren Burnett's disbursements to or on behalf of clients in the amount of $169,676.20 over reimbursements in the amount of $112,923.41, or $56,752.79, less other miscellaneous items of income and reimbursed expenses in the amount of $6,335.61, which were erroneously treated as recovery of disbursements to clients in arriving at the aggregate $50,416.18 (sic) deduction on their returns.

With respect to petitioners' income tax returns for 1958, 1959 and 1960, the Commissioner has made adjustments concerning Warren Burnett's disbursements to his clients similar to those in issue here. They are being contested in other proceedings before the Tax Court.

and petitioner's recovery experience, treated the disbursements as advances made to clients with the expectation, substantially realized, that they would be recovered and held that they were not deductible as business expenses. In addition, the Tax Court held that petitioner "failed to establish" a claim that, through inadvertence, there had been included in the figure for gross disbursements to clients used to compute the claimed business expense deduction in the amount of $50,417.18, (a) $24,562.42 paid to cover various court costs incurred in the preparation of clients' cases for trial (these costs were paid without any specific agreement with clients as to reimbursement and, according to petitioner's testimony, repayment was expected only if the litigation to which the costs related was successfully concluded), and (b) $10,292 paid to creditors of petitioner's clients out of their share of litigation recovery proceeds.[3] The court also remarked that the above claims were inconsistent with the facts stipulated by the parties.

The initial issue raised on appeal is whether the Tax Court's treatment of the disbursements as advances virtually certain of repayment rather than as business expenses, despite the fact that they were not made as formal loans for which the clients were personally liable, is supported by substantial record evidence. At the outset, we reject as without merit the contention that the Tax Court committed reversible error by refusing to hear the testi-

[3] Warren Burnett testified that the proceeds of collection out of which the alleged disbursements to creditors were made were included as income in his income tax return, so that the disbursements were merely offsets to his reported income.

mony of a Certified Public Accountant to the effect that it was proper accounting for petitioner to record the disbursements as expenses on his books. Whether the expenditures were properly characterized as expenses from the standpoint of sound accounting principles has no significant bearing on the issue presented here. The authorities are clear that labels or book entries given to expenditures do not control their deductibility as expenses. The true character of expenditures, which "depends on the 'special facts' of each case," *Dixie Mach. Welding & Metal Works, Inc. v. United States*, 315 F. 2d 439, 445 (5th Cir. 1963), determines their income tax consequences. See 4 Mertens, *Federal Income Taxation* §§25.13-.14 (1964).

To be deductible under Section 162(a), an expenditure must constitute an expense of carrying on a trade or business, as distinguished from some other type of expenditure made in connection with the taxpayer's business. See, *e.g.*, *Welch v. Helvering*, 290 U.S. 111, 115 (1933) (capital outlays not business expenses); *Swed Distributing Co. v. Commissioner*, 323 F. 2d 480, 483-85 (5th Cir. 1963) (distributions of profits not business expenses); 4 Mertens, *supra* §25.02 n.10 (loans are to be distinguished from expenses); §§25.14-.48. Moreover, it is well settled that an expenditure for which there is an unconditional right of reimbursement is not deductible as a business expense, see, *e.g.*, *Levy v. Commissioner*, 212 F. 2d 552 (5th Cir. 1954); *Morriss L. Groder*, 15 CCH Tax Ct. Mem. 1142, 1148 (1960), since "such expenditures are in the nature of loans or advancements . . ." 4 Mertens, *supra* §25.10 at 38n.98 (1960 rev.); *Id.* §25.10 at 200 (1965 cumm. supp.). And, this principle

has been relied upon to disallow claimed deductions for business expenses based on advances made by attorneys to, or on behalf of, their clients. *Henry F. Cochrane*, 23 B.T.A. 202 (1931) (attorney had absolute right to reimbursement); see *Reginald G. Hearn*, 36 T.C. 672 (1961) (record does not disclose whether clients' obligation to reimburse was absolute or conditional).

Petitioner argues, however, that the fact that the recovery of the disbursements involved here was conditional, i.e., if, when, and to the extent that a client's case was successfully concluded, renders the above principles inapposite and justifies treating the disbursements as business expenses which, if deemed ordinary and necessary would be deductible under Section 162(a). It is contended that no debt or loan can arise in the absence of an unconditional obligation to repay the money expended and that, therefore, there was no justification for the Tax Court's holding that petitioner's contingent disbursements constituted advances to clients, notwithstanding that they were made with the obvious expectation of reimbursement, and that a substantial portion of them were actually repaid.

It is essential to point out initially that the cases relied on by petitioner for the proposition that indebtedness requires an unconditional obligation to repay are not controlling here, for none of them deal with the question of what constitutes an expense for purposes of Section 162(a). Rather, they deal with the question of what constitutes a debt for purposes of Section 166 of the Internal Revenue Code of 1954, 26 U.S.C.A. §166 (deductions for bad debts),

see *Zimmerman v. United States*, 318 F. 2d 611 (9th Cir. 1963); *Evans Clark*, 18 T.C. 780 (1952), *aff'd*, 205 F. 2d 353 (2d Cir. 1953) (construing the comparable Section 23(k) of the Internal Revenue Code of 1939), or what constitutes indebtedness for purposes of the "interest paid" deduction provided for in Section 23(b), Internal Revenue Code of 1939. See *United States v. Virgin*, 230 F. 2d 880 (5th Cir. 1956) [Section 163(a), 26 U.S.C.A. §163(a) is the comparable section of the Internal Revenue Code of 1954]. The technical definition of indebtedness employed in the application of such provisions of the tax law, which deal in terms with indebtedness, cannot properly be invoked in this proceeding where the deductibility of an expenditure as a business expense under Section 162(a) is at issue. Here there is no occasion to define the expenditures precisely, and it is enough to determine negatively that they were not expenses of petitioner's business when made. *Cf. Glendinning, McLeish & Co. v. Commissioner*, 61 F. 2d 950, 952 (2d Cir. 1932).

We find that the record amply supports the Tax Court's conclusion that petitioner's expenditures constituted advances to his clients which were virtually certain to be repaid and, consequently, were not deductible as business expenses. Petitioner's contention that contingency of recovery, in and of itself, is sufficient reason for permitting the disbursements to be deducted fails to recognize that the question of whether an expenditure constitutes an expense within the meaning of Section 162(a) must be determined by examining the circumstances and conditions

under which it was made. Here there was a close correlation between the conditions of reimbursement and the primary criterion employed by petitioner to select clients to receive financial assistance, e.g., although reimbursement was tied to the recovery of a client's claim, assistance was granted only to those whose claims would in all probability be successfully concluded. Moreover, petitioner experienced a high rate of return on the advances, evidenced by the fact that during the five-year period ending in 1961 in which petitioner's conditional advances were made, only $4,417 out of approximately $290,000 of them became worthless. These factors clearly indicate that the advances were intended to, and did, operate as loans, i.e., advances virtually certain of repayment, to petitioner's clients. Under the circumstances, we agree with the Government that the Tax Court's decision in *Reginald G. Hearn, supra,* where it was determined that advancements by an attorney to his clients are not deductible as business expenses under Section 162(a), is highly persuasive. While the record in *Reginald G. Hearn* does not disclose whether the advances there were conditional, as petitioner's were here, the court's decision was greatly influenced by the fact that the taxpayer recovered a substantial portion of the advances ($3,018.49 out of a total of $3,639.94) shortly after they had been paid out. *Id.* at 674. Similarly, petitioner's recovery experience—as of the close of 1961 he had recovered 96% of the disbursements made in 1957; 83% of those made in 1958; 88% of those made in 1959; 75% of those made in 1960; and 34% of

those made in 1961—militates in favor of treating his disbursements to clients as non-deductible advances.[4]

In sum, the disbursements here were made only with the expectation that they would be substantially repaid, as evidenced by petitioner's high degree of selectivity in approving clients for financial aid (disbursements were to only 450 out of 2,200 clients represented by petitioner during the five-year period from 1957 to 1961). Moreover, there is nothing in the record to show that petitioner's rate of recovery under the contingent arrangement for repayment was any less than if his clients had assumed personal liability for repayment. Thus, the Tax Court properly characterized the disbursements as advancements virtually certain to be repaid, rather than dedutible business expenses.

The other issue raised by this appeal is whether petitioner's contention that sums aggregating $24,562.42, representing amounts paid for court costs in preparing clients' cases for trial, and $10,292, representing amounts paid to clients' creditors from proceeds recovered in their behalf, were inadvertently included in the $50,417.18 claimed as a business expense deduction for advances to clients, was properly dismissed by the Tax Court as without factual

[4] Petitioners attempt to discredit these facts by invoking the proposition that, the mere possibility of reimbursement of an actual business expense does not preclude its current deduction even though reimbursement actually occurs in a later tax period, is unpersuasive. The cases from which it is derived are inapposite, for they concern the possibility of recovering some or all of outright expenditures, i.e., actual expense items, not conditional advances such as those involved here which cannot be considered ordinary and necessary business expenses. See *Alleghany Corp.*, 28 T.C. 298 (1957); *Mel Dar Corp.*, 19 T.C.M. 290 (1960), *aff'd*, 309 F. 2d 525 (9th Cir. 1962), *cert. denied*, 372 U.S. 941 (1963).

support and as contrary to the stipulation of the parties? These claims were not contrary to the stipulated facts. The stipulation merely dealt with the total amount of disbursements made to, or on behalf of, petitioner's clients.[5] Moreover, the stipulation expressly permitted the introduction of evidence not at variance with the facts stipulated and the Government did not object when petitioner was asked to explain whether the total disbursement figure included court costs or other miscellaneous expenses.

The Government contends, however, that the "meager record showing" with respect to petitioner's claims justifies their rejection by the Tax Court. We do not agree. While it is true that the sole evidence in support of the claims is petitioner's testimony, he carefully itemized the expenditures comprising the alleged $24,562.42 of court costs, as follows: payments to medical experts $16,172.50; other witness fees $4,741.35; court costs $1,388.66; payments to court reporters $557.65; payments to interpreters $130.26; associate counsel fee $275.00; miscellaneous expenses $1,297.00. Moreover, he testified that he paid $10,292 on behalf of clients to their creditors contemporaneously with the conclusion of their cases and from the proceeds thereof. The above testimony was uncontroverted and the Government made no at-

[5] The Stipulation stated that "during the calendar year 1961 petitioner . . . made certain disbursements to and on behalf of his clients totalling $169,676.20, and he also recovered certain disbursements he had made to and on behalf of his clients in that year and in prior years totalling $112,923.41." In addition, it explained that the $50,416.18 (sic) deduction here in issue was the difference between those figures, less net items totalling $6,335.61 erroneously treated on petitioners' returns as recovery of disbursements to clients.

tempt to cross-examine petitioner with respect to the claim of inadvertence.

Of course, it is well recognized that questions of witness credibility and the weight to be given evidence are for the determination of the Tax Court. See, *e.g.*, *Midland Ford Tractor Co. v. Commissioner*, 277 F. 2d 111, 115 (8th Cir. 1960). However, the fact that petitioner's testimony was unchallenged, the fact that he specifically set forth the amounts and purposes of the alleged expenses incurred in trial preparation, and the fact that the Tax Court failed to indicate whether, or on what basis, it discredited petitioner's testimony, lead us to conclude that petitioner should be provided an opportunity to further substantiate his claims. Thus, while we agree that no deduction should be allowed for the advances to petitioner's clients, we remand this case to the Tax Court with the direction that it hear such evidence as is available concerning petitioner's claims (a) that he expended money for court costs and made payments to clients' creditors out of recovery proceeds, and (b) that such payments qualify as deductible expenses under Section 162(a) of the Internal Revenue Code of 1954.

United States Court of Appeals
FOR THE FIFTH CIRCUIT

October Term, 1965

No. 21884

D. C. Docket Nos. 409-63 and 410-63

WARREN BURNETT and EMMA BURNETT,
Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for Review of Decisions of the Tax Court of the United States (Texas Case).

Before RIVES, BROWN and MOORE,* Circuit Judges.

JUDGMENT

This cause came on to be heard on the petition of Warren Burnett and Emma Burnett, for review of decisions of the Tax Court of the United States, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered, adjudged and decreed by this Court the decisions of the Tax Court in this cause be, and the same are hereby remanded to the Tax Court with the direction that it hear

such evidence as is available concerning petitioner's claims (a) that he expended money for court costs and made payments to clients' creditors out of recovery proceeds, and (b) that such payments qualify as deductible expenses under Section 162(a) of the Internal Revenue Code of 1954.

February 15, 1966

---

* Of the Second Circuit, sitting by designation.

Issued as Mandate: April 15, 1966

In the

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 21884

WARREN BURNETT and EMMA BURNETT,
Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for Review of a Decision of the Tax Court of the United States.

(April 5, 1966)

ON PETITION FOR REHEARING

Before RIVES, BROWN and MOORE*, Circuit Judges.

PER CURIAM:

The petition for rehearing filed by the Petitioners in this cause is hereby DENIED.

---

* Of the Second Circuit, sitting by designation.

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 313

WARREN BURNETT AND EMMA BURNETT, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioner,[1] an attorney specializing in personal injury and workmen's compensation litigation on a contingent fee basis, made advances to selected clients to provide for their living expenses while he handled their claims. These advances were made with the understanding that repayment would occur when and to the extent that petitioner was successful in effecting a recovery on the client's claim. From 1957 to 1961, such advances were made to 450 of the approximately 2,200 persons petitioner represented. Total advances

[1] Mrs. Burnett is a party because the income here in question was community property under Texas law. Mr. Burnett will be referred to as petitioner.

226-793—66

for each year ranged between $10,000 and $170,000. At the close of 1961 petitioner had recovered 96% of the 1957 advances, approximately 85% of the 1958 and 1959 advances, 75% of the 1960 advances, and 34% of the 1961 advances, and only $4,417 of advances had become totally worthless. This high rate of return was attributable to the fact that petitioner made advances only to those clients whose claims would in all probability be successfully concluded. (Pet. A1–A3, A8).

On his 1961 federal income tax return petitioner, a cash basis taxpayer, claimed a deduction for $50,417.18 described as "Advances to Clients Net of Collection on Settlement." With minor adjustments, this figure represented petitioner's advances to clients during the year ($169,676.20) less repayments by clients of prior advances ($112,923.14) (Pet. A3). The Commissioner of Internal Revenue disallowed the deduction for advances to clients. The Tax Court sustained the Commissioner, and the court of appeals affirmed. (Pet. A3, A4, A11.)

The decision below is correct, and there is no conflict of decisions or any other basis for further review by this Court.

The crux of this case is whether petitioner's advances of funds to his clients for living expenses are ordinary and necessary business expenses—in which case he is entitled to a deduction under 1954 Code § 162(a)—or whether such advances constitute loans or losses—in which case he is not entitled to a deduction unless or until the advance becomes worthless—1954 Code §§ 165 and 166. Two courts below have

held that since the petitioner's testimony and the records of actual repayments show that the advances were virtually certain to be repaid (Pet. A4, A7), they did not constitute deductible expenses.

The principal thrust of petitioner's argument is that the advances do not qualify as loans or debts in the technical sense because his clients were not under an unconditional obligation to repay (Pet. 7–9).[2] Properly rejecting this formalistic approach, the court of appeals pointed out that the question of deductibility as an ordinary and necessary business expense under Section 162(a) must be determined by examining all of the circumstances and conditions under which the outlay was made, and that the omission of an unconditional obligation to repay is only one factor to be considered (Pet. A7, A8). Significantly, the court of appeals observed, there is nothing in this record to indicate that petitioner's high rate of recovery would have increased if his clients had assumed personal liability for repayment (Pet. A9). The advances in issue, having virtually all of the characteristics of loans, cannot be regarded as amounts used up—*i.e.*, as expenses paid—at the time the advances were made.

Petitioner argues that if the decision below is permitted to stand, he may never receive a deduction for advances which are not repaid (Pet. 7–9). In making this argument petitioner ignores the fact that during

[2] Under this approach a financial institution might well claim a current deduction in the not unusual situation where it makes a loan secured by real estate or other property and the borrower is not personally liable for repayment.

the taxable year involved, he claimed and was allowed a deduction for "loss * * * on advances to clients in connection with cases closed in the taxable year" (R. 156).[3] Thus, it is apparent that only the timing of the deduction is involved here, not its forefeiture, and that the "harsh tax consequences" foreseen by taxpayer (Pet. 11) are imaginary.

The result below is consistent with all of the previous cases involving the deductibility of attorneys' advances to clients.[4] Nor does *RCA Communications, Inc.* v. *United States*, 277 F. 2d 164 (Ct. Cl.), conflict with the instant decision. In that case RCA was permitted to deduct dollar payments made to a New York florist in connection with a flowers-by-wire service originating in Berlin. The Commissioner argued for disallowance primarily on the theory that the service conducted by the corporation was illegal and that allowance of tax benefits would frustrate sharply defined public policy (p. 166). Deciding the primary issue for taxpayer, the Court of Claims also rejected the additional argument that the deduction should be denied because RCA anticipated reimbursement from the senders of the flowers (p. 167). At most, that case held that ordinary and necessary expenditures by

---

[3] "R" references are to the printed record before the court of appeals.

[4] See *Hearn* v. *Commissioner*, 309 F. 2d 431 (C.A. 9), certiorari denied, 373 U.S. 909 (attorney denied deductions for advances to clients for litigation costs); *Monek* v. *Commissioner*, decided February 25, 1966 (P-H Memo T.C., par. 66,110) (attorney denied deductions for advance of living expenses to clients); *Cochrane* v. *Commissioner*, 23 B.T.A. 202 (attorney had absolute right to reimbursement).

a taxpayer in the form of payments to its suppliers for services or merchandise are not made non-deductible merely because the taxpayer expects to pass the cost on to his customer. That case is clearly distinguishable from the instant one where petitioner has advanced or loaned funds to a client and expects the person to whom the funds were advanced to repay the loan.

The petition for certiorari should be denied.

Respectfully submitted.

THURGOOD MARSHALL,
Solicitor General.

MITCHELL ROGOVIN,
Assistant Attorney General.

GILBERT E. ANDREWS,
FRED E. YOUNGMAN,
Attorneys.

AUGUST 1966.

U.S. GOVERNMENT PRINTING OFFICE: 1966